



FASB Response to SEC Study on the Adoption of a Principles-Based Accounting System July 2004

Introduction

In July 2003, the staff of the Securities and Exchange Commission (SEC) submitted to Congress its *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (the Study). The Study includes the following recommendations to the Financial Accounting Standards Board (FASB or Board):

1. The FASB should issue objectives-oriented standards.
2. The FASB should address deficiencies in the conceptual framework.
3. The FASB should be the only organization setting authoritative accounting guidance in the United States.
4. The FASB should continue its convergence efforts.
5. The FASB should work to redefine the GAAP hierarchy.
6. The FASB should increase access to authoritative literature.
7. The FASB should perform a comprehensive review of its literature to identify standards that are more rules-based and adopt a transition plan to change those standards.

The Board welcomes the SEC's Study and agrees with the recommendations. Indeed, a number of those recommendations relate to initiatives the Board had under way at the time the Study was issued.¹ The Board is committed to continuously improving its standard-setting process. The Board's specific responses to the recommendations in the Study are described in the following sections of this paper.

¹ In October 2002, the Board issued a proposal, *Principles-Based Approach to US Standard Setting* (the Proposal). That Proposal was issued in response to concerns about the quality and transparency of financial reporting resulting from the increasing level of detail and complexity in the standards. In March 2003, the Board discussed the comments received on the Proposal (including input from the SEC staff) and decided to pursue a number of initiatives aimed at improving the quality of FASB standards as well as the standard-setting process.

Objectives-Oriented Standards

In the Study, the SEC staff recommends that “those involved in the standard-setting process more consistently develop standards on a principles-based or objectives-oriented basis” (page 4).² According to the Study (page 4), an objectives-oriented standard would have the following characteristics:

- Be based on an improved and consistently applied conceptual framework;
- Clearly state the accounting objective of the standard;
- Provide sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis;¹
- Minimize exceptions from the standard;
- Avoid use of percentage tests (“bright-lines”) that allow financial engineers to achieve technical compliance with the standard while evading the intent of the standard.

¹ In doing so, however, standard setters must avoid the temptation to provide too much detail (that is, avoid trying to answer virtually every possible question within the standard itself) such that the detail obscures or overrides the objective underlying the standard. [Footnote in original.]

The “objectives-oriented” approach to setting standards described above (and expanded upon in the Study) is similar to the principles-based approach described in the Board’s Proposal. After discussing the comments received on its Proposal, the Board agreed that its conceptual framework needs to be improved. This is because an internally consistent and complete conceptual framework is critical to a standard-setting approach that places more emphasis on the underlying principles that are based on that framework. Pages 8 and 9 of this paper further describe the Board’s activities related to the conceptual framework; the following sections address the other characteristics of an objectives-oriented approach addressed in the Study.

Format and Content of Standards

The Board agrees with the Study’s recommendation to improve the format and content of its standards. In particular, The Board agrees that the objective and underlying principles

² All page numbers refer to the Study (except where noted otherwise).

of a standard should be clearly articulated and prominently placed in FASB standards. In response to comments received on its Proposal, the Board agreed that although its existing standards are based on concepts and principles, the understandability of its standards could be improved by writing its standards in ways that (a) clearly state the accounting objective(s), (b) clearly articulate the underlying principles, and (c) improve the explanation of the rationale behind those principles and how they relate to the conceptual framework.

The Board is working on developing a format for its standards that will encompass the attributes of an objectives-oriented standard described in the Study, for example, describing the underlying objective of the standard in the introductory paragraphs, using bold type to set off the principles,³ and providing a glossary for defined terms.

In addition, the Board is working with a consultant to identify changes in the organization and exposition of its standards that will increase the understandability of those standards. Accounting standards by their nature will include many specific technical terms; however, the Board believes it can do a better job simplifying the language used in its standards to describe how to account for complex transactions. In addition, the Board will strive to apply other effective writing techniques to enhance constituents' understanding of FASB standards.

When discussing proposed accounting standards or specific provisions of a standard, many of the Board's constituents comment on whether a standard is "operational." Because that term can mean different things to different people, the Board decided to define the term *operational* for its purposes. The Board uses the term *operational* to mean the following:

- A provision/standard is comprehensible by a reader who has a reasonable level of knowledge and sophistication,
- The information needed to apply the provision/standard is currently available or can be created, and

³ The Board is considering using the black letter/gray letter style of the International Accounting Standards Board (IASB) and will use that style in its business combinations Exposure Draft. The Board intends to request constituent input on that style and will address the advantages and disadvantages of using that style in all FASB standards at a later date.

- The provision/standard can be applied in the manner in which it was intended.

The Board believes that if its standards are more understandable, they also will be more operational.

Implementation Guidance

As noted in the Board's Proposal, an approach to setting standards that places more emphasis on principles will not eliminate the need to provide interpretive and implementation guidance for applying those standards. Thus, the Board agrees that some amount of implementation guidance is needed in objectives-oriented standards in order for entities to apply those standards in a consistent manner. The Board uses the term *implementation guidance* to refer to all of the guidance necessary to explain and operationalize the principles (that is, the explanatory text in the standards section, the definitions in the glossary, and guidance and examples included in one or more appendices that help an entity apply the provisions in the standards section).

The Board believes that the amount of necessary guidance will vary depending on the nature and complexity of the arrangements that are the subject of the standard. The Board believes that there should be enough guidance such that a principle is understandable, operational, and capable of being applied consistently in similar situations. Judgment is required to decide how much guidance is needed to achieve those objectives, without providing so much guidance that the overall standard combined with its implementation guidance becomes a collection of detailed rules. Therefore, the amount and nature of implementation guidance will vary from standard to standard.

The Board believes that its primary focus should be providing broadly applicable implementation guidance, not providing guidance on relatively narrow and less pervasive issues, including, for example, issues that are specific to certain entities or industries. When developing that implementation guidance, the Board plans to apply the same guidelines that underpin objectives-oriented standards. For example, rather than consisting of a list of rules or bright lines, the implementation guidance would explain or expand on the principle(s) or objectives in the standard.

The Board intends to continue to include examples in its proposed and final standards. The Board will attempt to make examples as realistic as possible and have them relate to common transactions and events. Because examples help to illustrate the application and intent of the underlying principles in a standard, the Board believes examples should be viewed as additional guidance in applying and understanding the standards—not as rules that should be followed.

The Board also believes that it has a responsibility to provide interpretive guidance when a given standard is being misread or misapplied. That guidance generally will be provided in the form of Emerging Issues Task Force (EITF) consensuses or FASB Staff Positions, both of which are subject to Board approval. As the Board moves toward adopting a more objectives-oriented approach to setting its standards, the EITF and the FASB staff will adopt a similar approach in developing interpretive guidance that is consistent with the underlying principles of the relevant standard. The Board acknowledges that the SEC will continue to provide guidance as it deems necessary. In addition, other participants in the financial reporting system will continue to provide nonauthoritative forms of guidance.

Scope Exceptions

The Study appropriately points out that “. . . one of the factors that creates increased complexity and a tendency towards a rules-based approach to standard setting is the existence of scope exceptions in a standard” and that “a consequence of scope exceptions is increased complexity and the need for more rules” (page 31, emphasis in original).

The Study states the following:

In reality, establishing the proper scope of the standard is one of the more difficult challenges. The scope of a standard could range from very broad to very narrow. If the scope is too broad, the standard setter would be unable to provide sufficient guidance for the standard to be meaningful and useful to preparers and auditors. This is apt to generate a proliferation of exceptions. However, if the scope of the standard is too narrow, it would not have sufficient applicability to justify the time and effort of the standard setter, and may not capture all transactions with similar economic substance. [Page 31; footnotes omitted.]

An objective of having few, if any, scope exceptions in its standards was an important aspect of the Board’s Proposal. Thus, the Board agrees that accounting standards with

few, if any, exceptions to the principles will increase the extent to which similar transactions and events are accounted for similarly. This will thereby enhance comparability and reduce the level of detail and complexity that arises from exceptions. The Board acknowledges that it needs to be diligent in making rational and consistent scope decisions and that scope decisions that provide for fewer exceptions are desirable.

As the Board moves to an objectives-oriented approach to setting standards that minimizes the number of scope exceptions, it will need to address existing (legacy) scope exceptions, particularly those that result from specialized industry needs. The Study refers to the possible need for legacy scope exceptions and states that “. . . standard setters should judiciously determine when it is appropriate to allow a legacy exception to its objectives-oriented standards” (pages 35 and 36). As noted in the Study, the Board “will need to weigh the costs resulting from lack of comparability with the benefits of certain companies not having to undergo a change in accounting policy” (page 36).

Behavioral Changes

The Study discusses the importance of and need for preparers and auditors to exercise appropriate professional judgment in applying accounting standards based on the stated objectives and principles and consistent with the economic substance of transactions and events. The Study also correctly, in the Board’s view, points out that detailed rules, bright lines, exceptions, and treatment alternatives can act as a barrier to achievement of these objectives. In addition, the Study points out that while detailed rules and bright lines may increase the perceived consistency and comparability of financial information, they can result in “false comparability” and reporting based on form rather than substance. The Board agrees with all of those observations.

The Study also states, however, that a move toward more objectives-oriented standards will require shifts in attitude, behavior, and expertise of preparers and auditors. The Board believes that it may take several years or more for such attitudes and behavioral changes to take root. One reason for that belief is that preparers continue to request scope exceptions, scope exemptions, and treatment alternatives and to oppose changes that would eliminate existing scope exceptions and treatment alternatives. In addition, the Board’s recent experience suggests that many preparers and auditors have become

less willing to exercise professional judgment in areas involving accounting estimates, uncertainties, and inherent subjectivity. Instead, they have been requesting detailed rules and bright lines in an apparent effort to reduce the need for the exercise of judgment in inherently subjective areas. Increased accountability for the accuracy of financial information under the new requirements related to the Sarbanes-Oxley Act coupled with a fear of “second guessing” by enforcement agencies and the trial bar are frequently cited as reasons for this behavior.

The Board supports the conclusions of the Study regarding the importance of and need for the exercise of professional judgment in applying accounting standards and for limiting scope exceptions and treatment alternatives. Further, the Board is committed to working with the SEC, the Public Company Accounting Oversight Board (PCAOB), and constituents to foster the behavioral changes necessary to support the type of objectives-oriented accounting standards envisaged in the Study.

Asset-Liability View

The Study states that “. . . the revenue/expense view is inappropriate for use in standard-setting—particularly in an objectives-oriented regime” (page 30) and that “. . . the FASB should maintain the asset/liability view in continuing its move to an objectives-oriented standard setting regime” (page 42). As noted in the Study, FASB Concepts Statement No. 6, *Elements of Financial Statements*, gives priority (conceptual primacy) to the definitions of assets and liabilities by defining the other elements (equity, revenues, expenses, gains, and losses) in terms of changes in assets and liabilities. The Board agrees with the view expressed in the Study that analyzing the assets and liabilities and the changes in assets and liabilities in a given arrangement is the most appropriate approach to setting financial reporting standards and intends to continue to apply the asset-liability view in its standard-setting projects. The Board notes that application of the asset-liability view is not inconsistent with, and can accommodate, the development of financial reporting standards for aggregation, classification, and display of information about the components of enterprise performance.

Conceptual Framework

As noted in the Study, the FASB uses its conceptual framework in the process of developing accounting standards. The Board agrees with the Study's assertion that “. . . having a clear, consistent conceptual framework is a necessary step in facilitating a move towards a more objectives-oriented regime” (page 41). The Study states (page 42) that the FASB should make the following efforts at improving its conceptual framework as it moves toward a more objectives-oriented approach to setting standards:

1. More clearly articulate how the trade-offs among relevance, reliability, and comparability should be made,
2. Eliminate the inconsistencies between the discussion of the earnings process (found in SFAC No. 5) and the definition[s] of the elements of financial statements (found in SFAC No. 6), and
3. Establish a paradigm for selecting from among possible measurement attributes.

The Board is addressing certain necessary changes to its Concepts Statements in three of its current agenda projects. Specifically, the Revenue Recognition project is addressing the inconsistencies between earnings process and elements definitions. The Liabilities and Equity project is reconsidering the distinction between liabilities and equity and aspects of the liabilities definition. As part of the longer-term objectives of its Fair Value Measurement project, the Board will consider how the qualitative characteristics of relevance and reliability should be applied in selecting an appropriate measurement attribute. Those current projects address the first two recommendations for improving the conceptual framework (refer to items 1–3 above). As for the third recommendation, the Canadian Accounting Standards Board (AcSB), on behalf of the IASB and its liaison standard-setting partners, is currently undertaking a research project: measurement objectives—concepts. The FASB staff is following that research project closely and participating in it as appropriate. The purpose of the research is to identify the most appropriate measurement basis (or set of bases) for measuring assets and liabilities when accounting standards require initial recognition or remeasurement.

Most recently, the Board agreed to undertake a “conceptual framework improvements” project with a goal of making its conceptual framework clear, complete, and internally

consistent. At their joint meeting in April 2004, the IASB and the FASB agreed that such a project should be undertaken jointly, that is, that the Boards would work together to develop a single, complete, and internally consistent conceptual framework that would be used by both Boards. In undertaking that project, the FASB would complete and refine its existing framework rather than comprehensively reconsider all components of that framework. The Boards plan to identify and initially focus on troublesome unresolved issues that continue to reappear in different standard-setting projects and in a variety of different guises (crosscutting issues). The Boards believe that resolution of such “crosscutting” conceptual issues will enable more efficient development of consistent, converged, high-quality standards-level guidance. The following are examples of crosscutting issues:

- The term *probable*, which appears in the FASB’s assets and liabilities definitions (but not in its recognition criteria)
- The liabilities definition
- The accounting for contractual rights and obligations
- The “unit of account,” which involves both aggregation (including linkage) and disaggregation.

Once the crosscutting issues have been identified, those issues would be prioritized, with one of the determinants being how often and how soon those issues are likely to arise in standards-level projects. Another determinant would relate to interdependencies among the crosscutting issues, with higher priority being assigned to issues on which the resolution of other crosscutting issues depends. Still another determinant would involve issues that would foster convergence of the FASB’s and IASB’s frameworks.

Another aspect of the conceptual framework that the Board is considering enhancing relates to disclosures in the financial statements. The AcSB, on behalf of the IASB and FASB, is conducting basic research relating to a disclosure framework that would be part of the overall conceptual framework activity described above. Such a disclosure framework would provide a conceptual underpinning for making decisions about presentation and disclosure requirements for new accounting standards.

One U.S. Standard Setter

The Study states “under an objectives-oriented regime, there cannot be a proliferation of standard setters” (page 48) and clarifies that there “would be one standard setter (FASB)” (page 9). In late 2002, the FASB reached an agreement with the Accounting Standards Executive Committee (AcSEC) of the AICPA that gave the Board more direct control in setting standards. Following a transition period that should end in 2004, AcSEC will cease issuing Statements of Position, but continue to issue Audit and Accounting (A&A) Guides. The FASB staff will continue to review A&A Guides as well as changes to the current Guides. However, the Board will no longer clear the issuance of A&A Guides. A primary purpose of the staff review of the Guides will be to ensure that the Guides are not establishing interpretive authoritative guidance that should be provided by the FASB.

In January 2003, the Board increased its participation in the EITF’s process by adding two Board members to the EITF’s Agenda Committee and by requiring that all future EITF consensus decisions be subject to ratification by the FASB before they become effective. As a result of those actions, the FASB is the only designated standard setter in the United States.⁴

International Convergence

The Study states that “. . . a continuing shift by the FASB towards a more objectives-oriented regime should facilitate the convergence process” (page 44). The FASB is committed to working with the IASB and others toward the goal of producing a single set of high-quality accounting standards that can be used both domestically and internationally to support healthy global capital markets.

As noted previously, the FASB recently agreed to undertake a project with the IASB to develop a common conceptual framework. The FASB also is involved in several joint projects with the IASB. Joint projects involve sharing staff resources, making every

⁴ While the SEC has the ultimate statutory responsibility for the financial reporting system and will continue its oversight role with respect to the FASB, the SEC staff generally looks first to the FASB to address and resolve issues relating to accounting standards, referring matters it believes need to be addressed to the Board with the expectation that wherever possible, the Board, the EITF, or the FASB staff will provide the necessary guidance.

effort to contemporaneously issue for public comment Exposure Drafts and other due process documents, and promulgating similar accounting standards. Currently, the FASB and IASB are conducting joint projects to address Revenue Recognition, Business Combinations (purchase method procedures), and Reporting Financial Performance.

The two Boards also are pursuing a joint short-term convergence project that is expected to result in a number of standards that will achieve convergence in specified targeted areas. The scope of that short-term convergence project is limited to those differences between U.S. GAAP and International Financial Reporting Standards (IFRS) in which convergence around a high-quality solution appears achievable in the short term. Because of the nature of the differences, it is expected that a high-quality solution can usually be achieved by selecting between existing U.S. GAAP and IFRS. The topics currently being addressed by the FASB in its segment of the short-term convergence project include accounting changes and error corrections, earnings per share, exchanges of productive assets, income taxes, and inventory costs.

In addition, as noted in the Study the FASB and IASB have committed to coordinating their agendas whenever possible. At their joint meeting in April 2004, the Boards agreed that in principle, any significant accounting standard would be developed cooperatively with the objective of issuing the same or similar standard concurrently in the United States and in those jurisdictions that apply IFRS.⁵ Consistent with that, the Boards agreed to consider expanding the current joint agenda projects to include the FASB's liabilities and equity project and its project on criteria for liability extinguishment as well as the IASB's project on accounting for insurance contracts. In addition, after discussing a number of potential major projects that might be added to the joint agenda, the Boards agreed on three projects that should be considered for admission to the joint agenda as resources become available (employee benefits, leasing, and intangible assets). The Boards also agreed to evaluate opportunities for further convergence or improvements to financial reporting through one or more shorter-term projects related to financial instruments.

⁵ To facilitate issuance of same or similar standards, the FASB will be working with the IASB in its efforts to develop a more objectives-oriented format for its standards (as described on page 3 of this paper).

GAAP Hierarchy

The Study notes that because the conceptual framework is intended primarily to aid the FASB in its deliberations, the existing GAAP hierarchy places industry practice above the FASB's conceptual framework. The Study states that “. . . when the FASB completes its efforts to improve the conceptual framework, that body of literature should serve not only as a guide for the FASB in its subsequent deliberations, but also as a guide for accounting professionals as they attempt to resolve difficult issues in practice for which there is not clear guidance in the literature. The direct use of the conceptual framework by preparers and auditors to complement standards should permit standard setters to draft more succinct standards than they otherwise could” (page 45).

Members of the Board and staff have met with representatives of the PCAOB and the AICPA to discuss possible changes to the GAAP hierarchy. The Board agrees with the suggestion in the Study that the various levels of the GAAP hierarchy be eliminated and that the conceptual framework be given greater prominence. The Board plans to issue a document for public comment that will propose moving the GAAP hierarchy into the FASB literature. That proposal also will address the Board's long-term goal of creating two basic levels of literature: authoritative and nonauthoritative. Since that goal cannot be achieved until the long-term codification and simplification initiative described below is completed, the Board must develop an interim way to grandfather the existing GAAP hierarchy. The Board also must develop processes and procedures for reviewing the A&A Guides and changes that must be made to those Guides and to other literature that has been developed by standard setters other than the FASB (for example, AcSEC).

Access to Authoritative Literature

The Study notes that “one of the concerns and sources of frustration that accounting professionals have expressed is the lack of a single, searchable database containing all of the authoritative guidance” (page 48, footnote omitted). The Study states (page 49) that it is “reasonable and appropriate that the FASB should have the responsibility for developing and maintaining” such a database. Citing the funding mechanism for the

FASB put in place by the Sarbanes-Oxley Act, the Study states that “. . . the long-run goal should be for the FASB’s documents to be freely available” (page 49).

The Board agrees that a comprehensive searchable database is very desirable and recently hired a consultant to study the issues that must be resolved if the Board was to undertake a project to organize the accounting literature by subject area into a single authoritative, electronically searchable source. The Board acknowledges that development of such a database would require the resolution of numerous conceptual, financial, and logistical issues over a number of years. The FASB staff discussed a potential codification project with the SEC staff in June 2004. This potential project will also need to be discussed with and approved by the Trustees of the Financial Accounting Foundation (FAF). The Board also agrees that free access to a comprehensive database would be highly desirable and notes that its recent funding from the mandated accounting support fees might make this possible. However, any final decision about whether the potential database would be made freely available lies with the FAF Trustees.

In the meantime, the FASB is trying to improve its products in the following ways:

- a. Making FASB standards and Concepts Statements freely available for downloading at the FASB website (completed).
- b. Expanding the *Current Text* (which includes FARS) to include FASB Staff Positions, implementation guidance from staff question-and-answer documents, and references to AICPA literature, thereby improving the retrievability of those pieces of implementation guidance (completed).
- c. Making the current Financial Accounting Research System (FARS) system web-based and increasing the frequency of updates (in process).
- d. Issuing the *Original Pronouncements* in an “as amended” format (in process).

In addition, constituents are able to listen to public Board meetings free of charge via audio webcast and have access to project summaries on the website, which are updated after every Board meeting.

Comprehensive Review of Literature

Pages 9 and 62 include a table of recommended action items. One of those action items is for the FASB to perform a “comprehensive review of current standards to identify and address those that are rules-based.” As noted on page 41, the Board recently went

through a process of identifying and prioritizing potential future projects. The goal of that comprehensive review was to develop a longer-term coordinated technical agenda with the IASB (refer to page 11 of this paper). The Board does not plan to undertake a separate project to identify rules-based standards and replace them with objectives-oriented standards. However, it will consider whether existing literature is rules-based in making future agenda decisions, as well as the existing agenda criteria that pertain to improving financial reporting and achieving convergence. The FASB believes the areas needing more attention are those areas that either have no guidance or have guidance that is not functional, not those areas that have existing rules-based standards that are functional.

Conclusion

The Board hopes that this paper is responsive to the recommendations outlined in the Study. As noted in the Study, many of the recommended actions are already under way. The Board appreciates the ongoing dialogue with the staff of the SEC in working toward the common goal of ensuring that the U.S. financial reporting system is the best in the world and thereby increasing investor confidence in that system.